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Industry View
In-Line

Large Cap & Specialty Pharmaceuticals

When \$80B is not \$80B; HC reform quantified

We estimate that PhRMA's 10-yr \$80B deal with the Senate Finance Committee (SFC) will cost the industry about a quarter of that amount. Net of incremental sales, we calculate \$22B over ten years. Annually, we estimate a cost of \$4B per year, or 6% of total U.S. profits over 2010-2013. After 2013, we estimate a cost of \$1B per year, or 1% of total U.S. profits. Pharma's \$80B contribution will be offset by: 1) \$5B from incremental sales from the donut hole 50% discount program; 2) \$22B from additional seniors eligible for catastrophic coverage; and 3) \$35B from incremental sales from expanded Medicaid coverage (beginning 2014). See exhibit on right. Pharma could also take list price increases to offset negatives.

Healthcare reform as envisioned by Senate a potential stock multiple positive for pharma. We agree with the consensus view that resolution of healthcare reform would lift a pharmaceutical sector overhang and facilitate generalist money flows.

But investors need to bear in mind negative impact on earnings. The negative impact on earnings starts in 2010 but diminishes over time as pharmaceutical utilization grows. The increase in minimum Medicaid rebate (from 15.1% to 23%) will be retroactive to January 1, 2010, and pharma's funding of 50% of the "donut hole" coverage gap begins July 1, 2010. New Medicaid eligibility does not start until 2014.

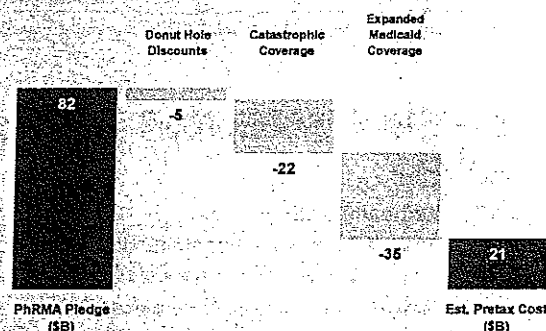
...And there is still marginal risk of a bigger hit to pharma coming out of conference committee. Given that the House of Representatives bill seeks to have HHS negotiate with pharma and apply Medicaid rebates to Medicare dual eligibles (low income seniors), there is a risk that Congress ends up tagging pharma more than expected. However, we assume Obama administration makes every effort to keep its \$80B promise to pharma – otherwise it risks a loss of credibility in other industry legislative processes (financial services, energy, etc.).

Our calculation of hit to industry profits

(\$B)	2010-2013	2014-2019
Net annual negative impact	(4.0)	(1.0)
Annual 2008 Industry Profits*	67.5	67.5
Percent of Total	6%	1%

*Assuming \$300B U.S. revenue, 30% pretax margin, 25% tax rate

The net cost of PhRMA's \$80B deal with the SFC reduced by three offsets



Source: CBO, Kaiser Family Foundation, Morgan Stanley Research

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There are 5 sections in this 9-page report: 1) When is \$80B Not Really \$80B?, 2) Donut Hole and Catastrophic Coverage Benefit, 3) Medicaid Coverage Benefit, 4) Caveats, 5) Appendix.

Exhibit 1

We estimate PhRMA's \$80B deal will cost \$22B net of incremental sales

(\$B)	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2010-19
PhRMA Pledge*	(\$4.6)	(\$6.5)	(\$7.2)	(\$7.5)	(\$8.0)	(\$8.5)	(\$9.3)	(\$9.7)	(\$10.2)	(\$10.8)	(\$82.3)
Cumulative cost to Pharma	6%	14%	22%	31%	41%	51%	63%	75%	87%	100%	
Incremental Sales	\$0.4	\$2.4	\$3.0	\$2.8	\$5.2	\$7.6	\$10.2	\$11.1	\$11.8	\$13.4	\$67.8
Incremental Operating Income	\$0.3	\$2.2	\$2.7	\$2.5	\$4.7	\$6.8	\$9.2	\$10.0	\$10.6	\$12.0	\$61.1
Cumulative ramp-up in incremental operating income	1%	4%	9%	13%	20%	32%	47%	63%	80%	100%	
Net Pretax Cost	(\$4.3)	(\$4.4)	(\$4.5)	(\$4.9)	(\$3.3)	(\$1.7)	(\$0.1)	\$0.3	\$0.4	\$1.3	(\$21.2)
Tax Benefit (Expense) at 25% marginal rate	\$0.5	\$0.5	\$0.5	\$0.7	\$0.2	(\$0.1)	(\$0.6)	(\$0.6)	(\$0.7)	(\$0.9)	(\$0.4)
Net After-Tax Cost	(\$3.8)	(\$3.9)	(\$3.9)	(\$4.3)	(\$3.0)	(\$1.9)	(\$0.6)	(\$0.4)	(\$0.3)	\$0.4	(\$21.7)
Percent of annual industry profits	-6%	-6%	-6%	-6%	-4%	-3%	-1%	-1%	0%	1%	-3%

*The \$23B industry fee is considered an excise tax, and thus, will not be a deductible expense against corporate taxes.

We estimate cost of donut hole discounts assuming program is effective 7/1/10; cost of Medicaid provisions are allocated according to CBO ests. of Subtitle F.

Source: Congressional Budget Office, Kaiser Family Foundation, Morgan Stanley Research

WHEN IS \$80B NOT REALLY \$80B?

When it's really \$22B

We estimate that PhRMA's contribution to health care reform will cost only \$22B net of incremental sales over the next ten years. *Investors should note that our estimates are theoretical and could be subject to significant revision.* Incremental sales from closing the Medicare Part D (outpatient senior drug benefit) donut hole and expanding Medicaid coverage could offset 75% of the total cost of PhRMA's pledge (see exhibit 1). We used data from the Congressional Budget Office's (CBO) analysis of the Patient Protection and Affordable Care Act released on Nov. 18, 2009 and from the Kaiser Family Foundation's analysis of Part D prescription drug spending in 2007 for our calculations. (Note: we refer to PhRMA's pledge as \$80B on the first page because that is how investors know the deal. However, the deal currently stands at \$82.3B as shown in exhibit 2).

The \$82.3B deal includes \$20B toward covering 50% of branded drug costs in the donut hole and \$38B toward increasing the Medicaid rebate from 15.1% to 23% and toward extending rebates to Medicaid HMO enrollees. We note that the Senate bill also includes a \$23B industry fee (excise tax) plus changes to the inflationary rebate, which would set base prices for new drug formulations equal to the base price of

existing formulations (see exhibit 2). In exchange, expanded Medicaid coverage and donut hole coverage will generate significant revenues for pharma. We allocate the costs of PhRMA's pledge as follows: we match the costs of donut hole coverage to start on Jul. 1, 2010; we match the costs of higher Medicaid rebates with the CBO's estimates of savings to the government; and we allocate the \$23B industry "fee" evenly over the 10-year period, or \$2.3B each year.

Exhibit 2

Estimated Breakdown of Original PhRMA Deal

(\$B)	Pledge
Medicare Part D Donut Hole Coverage	(\$20.4)
Total Medicaid Provisions	(\$38.4)
Increase Medicaid rebates (15.1% to 23%)	
Extend rebates to Medicaid HMO enrollees	
Expand 340B program	(\$0.5)
Industry Fee (excise tax)	(\$23.0)
Total 10-year PhRMA pledge (pretax)	(\$82.3)

Source: Morgan Stanley Research

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We estimate that the net after-tax cost of PhRMA's \$80B pledge could be \$22B.

Net of incremental operating income, we estimate a pretax cost of \$21.2B to pharma. However, the \$23B industry "fee" represents an excise tax that cannot be deducted against corporate income taxes. Although there will be some tax offsets during the early years of the deal, we anticipate a negative tax impact in out-years once incremental sales ramp up. Pharma will take the biggest hit to earnings over the early years of the deal. Over 2010-2013, we estimate an average negative earnings impact of 6% on total U.S. profits. As pharmaceutical utilization increases, we estimate that the negative impact on total U.S. profits will drop to 1% on average after 2013. We believe that the deal could even have a positive impact on total U.S. profits by 2019 (see exhibit 1).

We calculate additional operating income of \$61B cumulative over 2010-2019 (90% margin on \$68B in additional sales from the PhRMA deal)

We believe that these provisions position pharma to generate additional sales of \$68B over ten years, or \$6.8B per year on average (see exhibit 3). This would represent a 2% increase in revenues based on 2008 IMS sales of approx. \$300B. Assuming 90% pretax margins, we estimate \$61B in incremental operating income from the PhRMA deal.

Exhibit 3

We estimate \$68B in incremental sales from PhRMA deal over ten years

(\$B)	
Donut hole fill-in (starts July 1, 2010)	5
Catastrophic coverage* (starts July 1, 2010)	25
Expanded Medicaid coverage (starts 2014)	38
Total	68

*More patients pushed through the donut hole
Source: Morgan Stanley Research

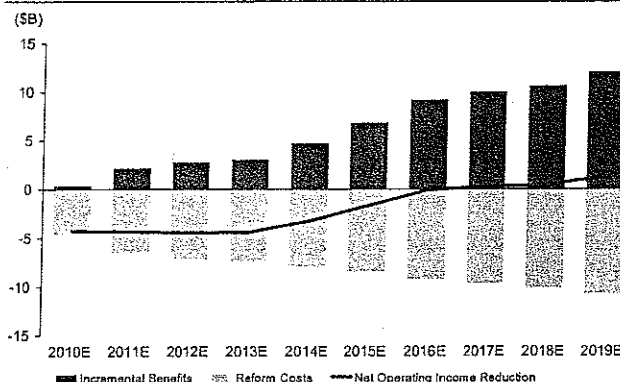
Majority of revenue offsets will not begin until 2014

We compare the incremental positives and negatives of the PhRMA deal in exhibit 4. Pharma would take the biggest hit during the early years of the deal since many costs would be incurred irrespective of any offsetting revenue. For example, the increase in the Medicaid rebate would be effective Jan. 1, 2010 while eligibility would not expand until 2014. Over 2010-2013, we estimate a 6% hit to total U.S. profits based on \$300M in total sales, 30% pretax margin and 25% marginal tax

rate. After incremental sales ramp-up, we calculate a 1% negative hit to earnings over the 2014-2019 period. Pharma's net cost diminishes in the middle of the decade and could turn positive in 2019.

Exhibit 4

Hit to operating income diminishes after 2013 once incremental sales ramp up



Source: Congressional Budget Office, Kaiser Family Foundation, Morgan Stanley Research

We do not believe that the PhRMA deal will be a net positive for the industry over the next ten years.

One estimate pointed to \$115B in incremental drug sales from the PhRMA deal. According to a recent "The Pink Sheet" article, some staffers on the Democratic Finance Committee hypothesized that the \$23B industry fee (excise tax) was calculated from a 20% fee based on incremental pharma sales over the next 10 years from health care reform. They backed into \$115B in incremental pharma revenue. Based on 2008 IMS sales of approx. \$300B, this would translate to 4% sales growth from the PhRMA deal alone, which is double our estimate of 2%. For comparison, the incremental sales benefit from Medicare Part D was approx. 3-4% in 2006. But SFC has rebuked that estimate and asserts that the \$23B industry fee is not based on any particular revenue assessment.

Exhibit 5

PhRMA deal could boost industry sales by 2%

(\$B)	10-Year Total	Avg. Yrly Sales	% of Total Industry Sales
Part D Donut Hole Coverage	\$29.4	\$2.9	1.0%
Expanded Medicaid Eligibility	\$38.4	\$3.8	1.3%
Total Incremental Sales	\$68	\$6.8	2.3%
Incremental COGS/ OpEx	\$6.8	\$0.7	
Incremental Operating Income	\$61	\$6.1	2.1%

Source: Company data, Morgan Stanley Research

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We do not expect Healthcare Reform to be as big a boost to drug sales as Medicare Part D was (particularly before Medicaid coverage is expanded).

Before 2014, we only expect some benefit from 50% donut hole coverage. And the sales benefit from additional Medicaid coverage starting in 2014 will be limited by the number and mix of incremental insureds under both plans. Under the PhRMA deal, Medicaid eligibility would be extended to 15M additional people by 2019, versus 25M seniors who enrolled in Medicare Part D in 2006. Further, we expect incremental Medicaid drug spending to be skewed toward acute care for single parents and children (i.e. vaccines and prenatal care) and generic drugs. In contrast, Part D coverage is skewed toward seniors and more expensive chronic care.

Medicare Part D boosted drug sales by 3-4% in 2006.

For reference, we estimate that Part D was responsible for 3-4% of total growth in drug sales in 2006. The rate of growth in drug sales was approx. 6% in 2005, one year before Medicare Part D went into effect. In 2006, the first year that seniors were eligible for Part D, drug sales increased 9% to approximately \$280B. The boost from Medicare Part D was short-lived. The rate of growth in drug sales declined to 4% the following year (see exhibit 6 and 7).

Exhibit 6

Peak in growth rate of drug sales coincided with the launch of Medicare Part D in 2006

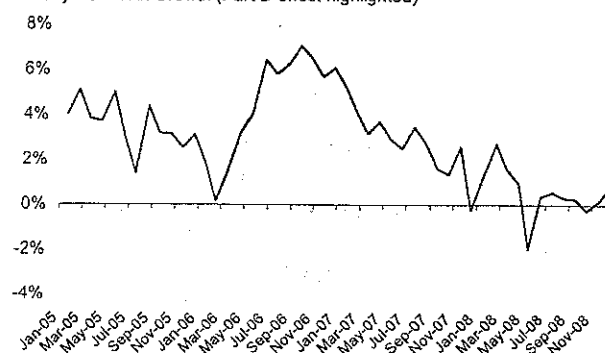
	2004	2005	2006	2007	2008
Sales (\$B)	\$ 240	\$ 254	\$ 277	\$ 288	\$ 292
YOY Growth		6%	9%	4%	1%
TRx (M)	3,435	3,545	3,706	3,807	3,843
YOY Growth	3%	3%	5%	3%	1%

Source: IMS Health, Morgan Stanley Research

Exhibit 7

Part D was a short-lived boost to TRx growth

Monthly YOY TRx Growth (Part D effect highlighted)



Source: IMS Health, Morgan Stanley Research

TWO PART D SALES BENEFITS -- DONUT HOLE & CATASTROPHIC COVERAGE

We expect \$26.5B in incremental operating income from donut hole and catastrophic coverage in Medicare Part D

PhRMA will contribute \$20B to offer 50% discounts for drugs purchased in the donut hole. But we expect a \$26.5B increase in drug demand on the heels of this program. This includes two components: \$4.6B from seniors who would otherwise reduce spending in the donut hole and \$21.9B from additional seniors who progress into the catastrophic coverage phase (see exhibit 8 on next page). Hence, we calculate that incremental drug spending in the donut hole and catastrophic coverage phase will more than offset the 50% Part D rebate pledge of \$20.4B.

Greater sales in the donut hole explained; we expect \$4.6B in incremental operating income

In 2007, 3.4M seniors were subject to the donut hole (14% of all Part D participants). On average, seniors remained in the donut hole for 4 months and reduced drug spending by 11% while subject to the gap. Based on data from the Kaiser Family Foundation, we estimate that pharma stands to lose \$700M in sales in 2010 if the donut hole continues to grow. Under health care reform, we estimate pharma can recover half of those sales and generate incremental operating income of \$300M in 2010. We estimate that annual incremental operating income will grow to \$600M by 2019 (see exhibit 8 and Appendix). **For simplicity purposes, we are assuming that 50% donut hole coverage starting July 1 yields essentially a full year benefit to sales since a majority of seniors hit the donut hole in the second half of the year. However, we note that**

this may overstate the revenue benefit because some seniors may have used more pharmaceuticals in 2010 if they had 50% donut hole coverage prior to July 1st.

Greater catastrophic coverage sales explained; we estimate that seniors being "pushed through" the donut hole to catastrophic coverage will generate \$21.9B in incremental operating profit for pharma

In their Nov. 18 score of the Senate health reform bill, CBO estimates that increased catastrophic coverage will cost Medicare \$19.5B. We assume that these incremental costs to the government are 80% of incremental revenues for pharma. Pharma's revenues will be higher than \$19.5B because Medicare only pays for 80% of drug costs in the catastrophic phase (plan contributions and coinsurance make up the rest). Hence, we estimate \$24B in incremental sales over the next

decade. Assuming a 90% incremental pretax margin on these additional sales, we estimate an additional \$21.9B in operating profits to the industry.

More Part D beneficiaries will progress into the catastrophic coverage phase as their financial obligation in the donut hole is effectively halved by the PhRMA deal. Although pharma will offer 50% discounts for drugs purchased in the donut hole, Medicare will base eligibility for catastrophic coverage on pre-discount prices. More seniors will reach the catastrophic coverage phase earlier each year.

We note that although CBO overestimated the cost of Part D, it is impossible to know if it is over or under-estimating new pharmaceutical spending under Healthcare Reform.

Exhibit 8

We Calculate A Net Benefit From Donut Hole Coverage

(\$B)	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2010-19
Incremental Sales from Donut Hole Coverage											
Dollar value of coverage gap per enrollee (\$0s)*	3,756	4,026	4,315	4,624	4,956	5,312	5,693	6,102	6,540	7,009	
Annual reduction in drug spending per enrollee (\$0s)**	(214)	(229)	(246)	(263)	(282)	(303)	(324)	(348)	(372)	(399)	
Opportunity cost to Pharma (lost sales in \$B) ⌘	(\$0.7)	(\$0.8)	(\$0.8)	(\$0.9)	(\$1.0)	(\$1.0)	(\$1.1)	(\$1.2)	(\$1.3)	(\$1.4)	(\$10.1)
Incram. sales from donut hole coverage †	\$0.4	\$0.4	\$0.4	\$0.4	\$0.5	\$0.5	\$0.6	\$0.6	\$0.6	\$0.7	\$5.1
Incram. Op. Income from donut hole coverage ◊	\$0.3	\$0.4	\$0.4	\$0.4	\$0.4	\$0.5	\$0.5	\$0.5	\$0.6	\$0.6	\$4.6
Incremental Sales from Additional Part D Enrollees Reaching the Catastrophic Coverage Phase											
Incremental Costs to Medicare ♣	\$0.0	\$1.6	\$2.1	\$1.9	\$1.8	\$1.8	\$2.2	\$2.4	\$2.5	\$3.2	\$19.5
Incremental Drug Sales ♪	\$0.0	\$2.0	\$2.6	\$2.4	\$2.3	\$2.3	\$2.8	\$3.0	\$3.1	\$4.0	\$24.4
Incremental Operating Income ◊	\$0.0	\$1.8	\$2.4	\$2.1	\$2.0	\$2.0	\$2.5	\$2.7	\$2.8	\$3.6	\$21.9
Total Cost of Medicare Donut Hole Coverage	(\$20.4)										
Incremental Operating Income	\$26.5										
Net Benefit (Cost) to Pharma	\$6.1										

Footnotes and Comments

* Kaiser estimates that the gap will double from \$3051 in 2007 to \$6102 in 2017 (7.2% CAGR). We continue to grow our donut hole estimates by 7.2% b/t 2017-19.

** Between 2007-17, we estimate that the reduction in drug spending by enrollees subject to the gap grows at the same rate as the coverage gap (7.2% CAGR).

⌘ Kaiser estimates that 3.4M seniors were subject to the coverage gap in 2007. For simplicity, we assume that estimate remains constant between 2007-2019.

† We estimate that Pharma can recapture 50% of lost sales after coverage gap discounts are implemented.

◊ We assume 90% incremental pretax margins. These estimates do not include the cost of Part D discounts. These costs are already reflected in PhRMA's pledge.

♣ Congressional Budget Office Estimates (numbers may not add due to rounding).

♪ We assume that incremental costs to Medicare translate into additional drug sales. Note: Medicare only covers 80% of the cost of drugs in catastrophic coverage.

MEDICAID COVERAGE BENEFIT

Expanded Medicaid/CHIP coverage will cover an additional 15M non-elderly people.

PhRMA pledged \$38B toward increasing the Medicaid rebate from 15.1% to 23.1%, toward extending rebates to Medicaid HMO enrollees, and toward adding an additional rebate for new formulations of existing drugs. These provisions will be applied for drugs dispensed after Dec. 31, 2009. In exchange, Medicaid/CHIP coverage will be extended to 6M non-elderly people with incomes below 133% of the federal poverty line beginning in 2014. By 2019, that number will grow to 15M people. In their Nov. 18 score of the Senate bill, CBO estimates that incremental Medicaid/CHIP outlays will add \$384B to the federal deficit. However, the total cost will be higher because the CBO estimates do not include state contributions (approx. 10% of the total cost). Although the Federal government and individual states typically split Medicaid costs 60-40, the Federal government will pay for 90% of incremental Medicaid enrollees on average.

We estimate \$34.6B in incremental operating income over the next decade, which will not fully offset PhRMA's Medicaid contributions.

We estimate that approx. 9% of incremental Medicaid spending will go toward outpatient prescription drugs, or \$417 per incremental enrollee in 2014 and \$580 per incremental enrollee in 2019 (7% CAGR). For reference, we estimate that Medicaid prescription drug spending averaged \$280 per enrollee in 2007 based on 53M Medicaid enrollees and \$15B in total out-patient prescription drug expenditures (per Kaiser estimates). Medicaid expansions could translate to incremental pharma revenue of \$2.5B in 2014, which we expect to grow to \$8.7B by 2019. Assuming incremental pretax margins of 90%, we estimate \$34.6B in incremental operating income over the next decade from Medicaid expansions (see exhibit 9). Net of additional operating income, we estimate a net cost of \$3.8B to pharma over the next ten years.

Exhibit 9

Pledges For Medicaid Not Fully Offset By Expanded Medicaid Coverage

(\$B)	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2010-19
Cumulative Additional Medicaid/CHIP Beneficiaries (M)*					6	10	14	14	15	15	
Incremental Federal Medicaid/CHIP Outlays*					\$25.0	\$48.0	\$69.0	\$75.0	\$80.0	\$87.0	\$384.0
Incremental Federal + State Medicaid/CHIP Outlays*					\$27.8	\$53.3	\$76.7	\$83.3	\$88.9	\$96.7	
Incremental Drugs Sales**					\$2.5	\$4.8	\$6.9	\$7.5	\$8.0	\$8.7	\$38.4
Incremental Drug Sales per Additional Medicaid enrollee					\$417	\$480	\$493	\$536	\$533	\$580	
Incremental Operating Income ◇					\$2.3	\$4.3	\$6.2	\$6.8	\$7.2	\$7.8	\$34.6
Total Cost of Medicaid Provisions					(\$38.4)						
Incremental Operating Income					\$34.6						
Net Benefit (Cost) to Pharma					(\$3.8)						

Footnotes and Comments

*Congressional Budget Office estimates.

**We estimate that outpatient drug spending will equal 9% of incremental Medicaid spending.

▣ CBO notes that the Federal government will pay on avg. 90% of incremental Medicaid costs (Federal government typically pays about 57% of Medicaid spending)

◇ We assume 90% incremental pretax margins.

Source: Company data, Morgan Stanley Research

CAVEATS

The healthcare debate remains in flux

PhRMA scored a significant victory when Sen. Bill Nelson's amendments to the SFC bill were defeated on Sept. 24. Nelson sought to impose \$110B in new costs on the pharmaceutical industry, of which \$53B would be used to close the donut hole. Although PhRMA's \$80B contribution appears safe for now, Nelson has indicated that he may re-introduce his amendments when the bill hits the Senate floor for debate. Pharma's situation could potentially worsen once the entire Senate debates the bill. Additionally, the House version is more onerous to pharma. The House's plan to extend Medicaid rebates to dual eligibles and give HHS direct pricing authority could theoretically push pharma's cost to \$140B.

We based many estimates on extrapolated data

We used Medicaid Part D spending data from 2007 to estimate the incremental benefit from donut hole coverage.

Comprehensive data for 2008 is not available. We believe that the donut hole has affected more seniors since 2007 (Kaiser estimate was 3.4M). As a result, there may be greater upside to incremental operating income from donut hole coverage. Additionally, our estimates are sensitive to CBO estimates. We take our data from the most recent CBO score released Nov. 18. We note that the CBO revised their estimates on incremental Medicaid costs and Part D spending twice since their original score released Sep. 16. Should future CBO estimates contain similar upward revisions, we would expect greater upside to our incremental sales estimates.

APPENDIX

Brief overview of the Part D donut hole

In 2007, Part D plans paid for 75% of total drug costs up to \$2,400 (after a \$265 deductible). Between \$2,400 and \$5,451 in total drug costs, seniors were responsible for 100% of those costs (hence, the coverage gap or "donut hole"). The donut hole of \$3,051 in 2007 is expected to double by 2017 (7.2% CAGR) according to Kaiser. In 2009, the coverage gap is \$3,454. The coverage beyond the upper end of the donut hole (\$5,451 in 2007) is called catastrophic coverage. Medicare pays 80% of catastrophic coverage and the plan pays 15% (total coverage 95%).

In August 2008, the Kaiser Family Foundation published their analysis of prescription drug spending by seniors subject to the Part D coverage gap during 2007 (the first full year of enrollment in Part D plans for many beneficiaries). **Based on IMS data, Kaiser estimated that 3.4M seniors were subject to the donut hole in 2007 (14% of all Part D participants). Our estimates do not reflect the fact that more seniors are likely subject to the donut hole today.**

Using data from Kaiser's analysis of 2007 Part D drug spending, we estimate that seniors reduced drug spending by an average of 11% per month while subject to the donut hole

Kaiser notes that the average reduction varies based on when seniors reach the donut hole during the calendar year. While subject to the donut hole, Kaiser found that 20% of seniors subject to the coverage gap stopped taking their medication completely, skipped doses, or switched to cheaper alternatives. A similar study published by *Health Affairs* in Feb. 2009 found that seniors who entered the donut hole (but did not reach the catastrophic phase) reduced monthly drug spending by 11% in 2006.

Exhibit 10

Total Drug Spending by Part D Enrollees who Reached the Coverage Gap in 2007

When Enrollee Reached Coverage Gap	% of Enrollees	Avg. Monthly Spending Pre-Gap	Avg. Monthly Spending During Gap	Reduction in Drug Spending
January-March	5%	\$1,063	\$713	-33%
April-June	23%	\$509	\$395	-22%
July-September	35%	\$318	\$293	-8%
October-November	37%	\$229	\$259	13%
Weighted Avg. Mthly Spending		\$366	\$325	-11%
Average Months in Gap		4.2		
Weighted Avg. Yrly Spending		\$4,395	\$4,221	-4.0%
				(\$174)

Source: Kaiser Family Foundation, Morgan Stanley Research

We estimate \$364M in incremental revenues from donut hole coverage in 2010

We estimate that average monthly drug spending reduced from \$366 prior to the coverage gap to \$325 during the coverage gap in 2007. On average, seniors remain in the donut hole for 4.2 months. Annualized, we estimate that seniors subject to the coverage gap reduced annual drug spending by 4% on average (see exhibit 10). For simplicity, we assume that pharma could have recaptured 50% of these lost sales had the PhRMA deal been in place. We estimate that incremental revenue from donut hole coverage would have been \$295M in 2007 (based on 3.4M Part D enrollees who were subject to the donut hole). We grow our estimate of incremental revenue to match the CAGR of the donut hole estimated at 7.2% between 2007-2017. In 2010, we estimate that the incremental sales to pharma will be \$364M from 50% donut hole coverage (excluding the benefit from more seniors progressing into catastrophic coverage) (see exhibit 7). Assuming a 90% pretax margin on incremental sales, we estimate incremental operating income of \$5B over ten years. **For simplicity purposes, we are assuming that 50% donut hole coverage starting July 1 yields essentially a full year benefit to sales since a majority of seniors hit the donut hole in the second half of the year. However, we note that this may overstate the revenue benefit because some seniors may have used more pharmaceuticals in 2010 if they had 50% donut hole coverage prior to July 1st.**

Further reading:

- The Medicare Part D Coverage Gap: Costs and Consequences in 2007, *The Henry J. Kaiser Family Foundation*, August 2008.

www.kff.org/medicare/upload/7811.pdf

- Congressional Budget Office's analysis of the Patient Protection and Affordable Care Act, Nov. 18, 2009.

www.cbo.gov/doc.cfm?index=10731

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Global Stock Ratings Distribution

(as of October 31, 2009)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	875	37%	277	40%	32%
Equal-weight/Hold	1082	46%	318	46%	29%
Not-Rated/Hold	26	1%	3	0%	12%
Underweight/Sell	392	17%	87	13%	22%
Total	2,375		685		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

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Industry Coverage: Large Cap & Specialty Pharmaceuticals

Company (Ticker)	Rating (as of)	Price (11/20/2009)
David Risinger		
Bristol-Myers Squibb Co (BMY.N)	++	\$24.46
Eli Lilly & Co. (LLY.N)	U (07/14/2009)	\$36.59
Forest Laboratories Inc. (FRX.N)	O (11/03/2009)	\$29.57
Merck & Co., Inc. (MRK.N)	E (11/12/2009)	\$36.46
Pfizer Inc (PFE.N)	O (09/10/2009)	\$18.36

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